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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945.

No. 93

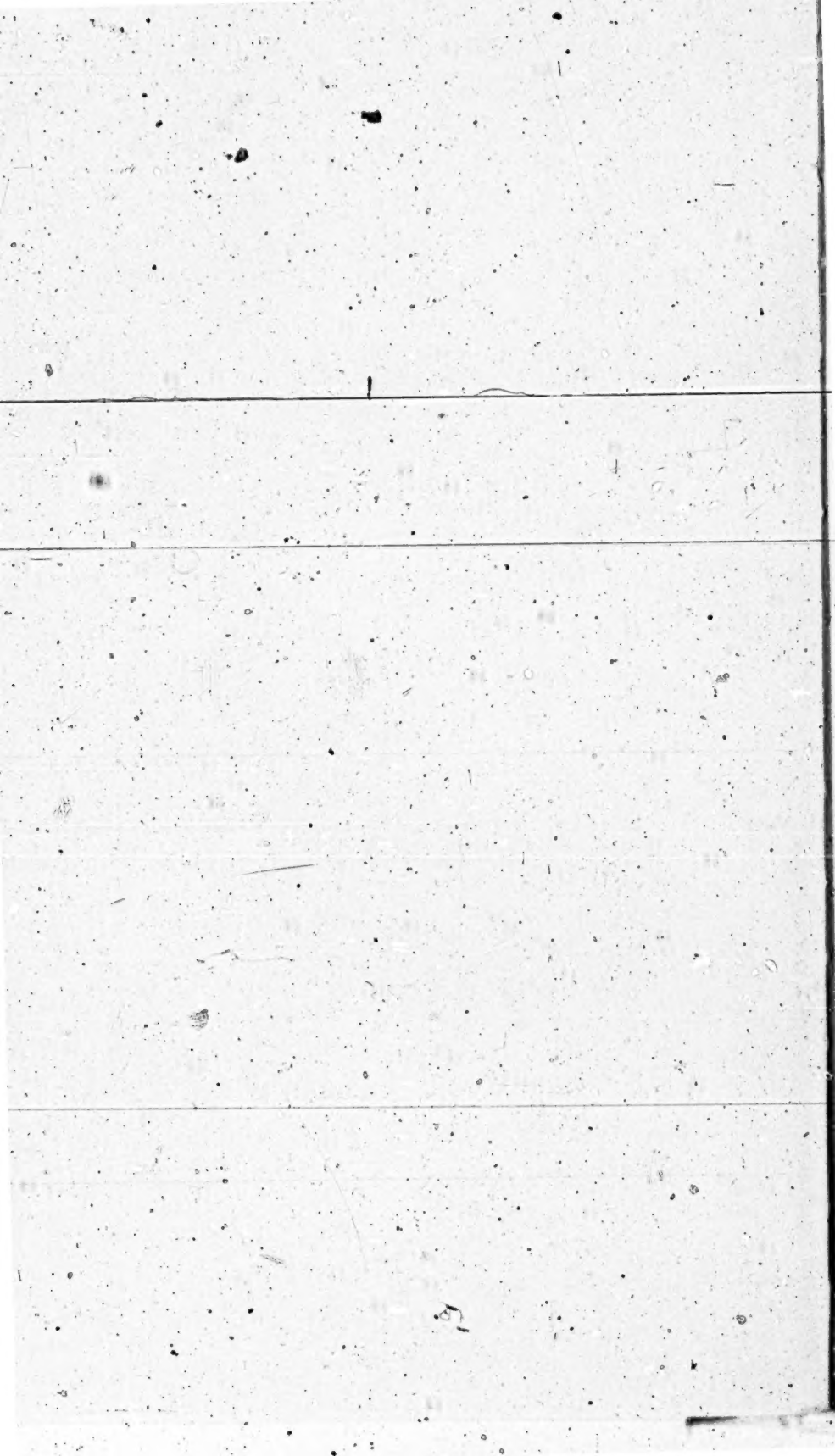
HERCULES GASOLINE COMPANY, Inc.,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF FOR PETITIONER.

✓ Melvin F. Johnson,
Counsel for Petitioner;
✓ Joseph H. Jackson,
Of Counsel for Petitioner.



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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945.

No. 93

HERCULES GASOLINE COMPANY, Inc.,
versus **Petitioner,**

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF FOR PETITIONER.

This is a proceeding to review a judgment of the Circuit Court of Appeals for the Fifth Circuit involving the undistributed profits tax. The Court granted the petition for writ of certiorari under date of October 8, 1945.

Opinion Below.

The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 81-86) is reported in 147 F. (2d) 972.

Jurisdiction.

The jurisdiction of this Court is invoked under Sec. 240 (a) of the Judicial Code, as amended (28 U.S.C.A. 347 (a)).

Statute Involved.

The statute involved is Sec. 26 of the Revenue Act of 1936, 49 Stat. 1648, 1664 (26 U.S.C.A. Int. Rev. Acts, pages 835-6); the relevant portions of the statute reads as follows:

Sec. 26. Credits of Corporations:

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

.

(c) Contracts Restricting Payment of Dividends.

(1) Prohibition on payment of dividends.

An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. . . . Cf. Appendix 29.

Statement of Case.

Hercules Gasoline Company, Inc. was organized in 1933 under the Business Corporation Law of Louisiana (Act 250 of the Legislature of La. for the year 1928). The original charter of the corporation described the kinds, rights, privileges and conditions of the capital stock and expressly provided that there could be no dividend on the common stock until all of the preferred stock had been retired, redeemed and discharged. Every certificate of

stock carried on its face a specific reference to this charter provision. Petitioner maintains that it is entitled to credit against the surtax on corporate profits for the year 1937 because the provisions in the outstanding stock certificates prohibiting the payment of dividends met all requirements of the law for the allowance of the credit.

Facts.

The findings of fact and opinion of the Tax Court are in the Record, pages 64 to 73, inclusive.

The facts are not in dispute and the issues of the controversy have been reduced to the sole question whether provisions in a corporate charter and stock certificates prohibiting the payment of dividends constitute a written contract executed by the corporation for which the corporation is entitled to credit against any surtax on corporate profits under Sec. 26 (c) (1) of the Revenue Act of 1936. The Commissioner of Internal Revenue in 1942 (R. 14) sent to petitioner a notice of deficiency in income tax for the taxable year 1937 in the amount of \$32,481.53 as concerns the surtax on undistributed profits (R. 19). The deficiency claimed by the Commissioner grew out of numerous adjustments made by him to the tax return of the corporation for the year in question, principally involving the denial by him of credit against surtax upon undistributed profits. The corporation had taken credit against this surtax by virtue of a contract between the corporation and the holders of its preferred stock.

Hercules Gasoline Company, Inc., the Louisiana corporation, was in existence in 1937, the tax year in-

involved, and was dissolved and liquidated in 1939. Petitioner is a Delaware corporation, organized in 1939, domiciled in Wilmington, and it succeeded as transferee to the assets and liabilities of the La. corporation. Petitioner filed petition to the U. S. Board of Tax Appeals (now the Tax Court of the U. S.) seeking a redetermination of its tax liabilities for the year in question alleging that the Commissioner erred in making each and every one of the adjustments claimed by him. (R. 2-20). After trial, the Tax Court entered its decision upholding the Commissioner (R. 64-73) and the case was appealed to the United States Circuit Court of Appeals for the Fifth Circuit, which affirmed the decision of the Tax Court. (R. 81-86).

The original charter of the La. corporation, drawn and adopted pursuant to Act 250 of Louisiana for the year 1928, contained Article V giving the rights, privileges and conditions of the shareholders. (R. 65-6). Subsection (c) of this article reads as follows:

(c) The common stock shall be subject to the prior rights of the holders of the preferred stock as above declared and there shall be no dividend on the common stock until all of the preferred stock has been retired, redeemed, and discharged.

In 1935, an amendment to the charter was filed and recorded merely increasing the authorized number of shares of preferred stock from 400 to 1400, but retaining the same restriction as to dividends. At the stock-

holders' meeting, held in 1935, the following resolution was adopted:

RESOLVED, That the preferred stock be issued at par to any creditor willing to accept same in full payment of his claim. (R. 67).

Thereupon the outstanding preferred stock issue was increased from 400 to 1294 shares. All of the certificates of stock, whether issued before or after the amendment to the charter, contained the following stipulation:

FOR RIGHTS AND VOTING POWERS OF PREFERRED STOCK, SEE ARTICLE V OF CHARTER (R. 67).

In 1937, the tax year in question, there was outstanding and due by the corporation, having been issued in 1933 and 1935,—even before the law was enacted,—the amount of 1294 shares of preferred stock of the par value of \$50.00 per share, a total of \$67,000.00, (R. 46; 67). This preferred stock was not redeemed and cancelled until May 13, 1939. No dividend or distribution was made to the common stockholders until after the complete payment and retirement of the preferred stock issue. (R. 61).

There is no dispute as to the facts. Petitioner does not disavow transferee liability. There is no denial concerning the issue of this stock, either as to amount, time issued or conditions when sold to the holders. Neither is there any question that it was issued and outstanding prior to May 1, 1936, nor that it expressly deals with the payment of dividends. The Commissioner first raised the point in his 90 day letter that the preferred stock certifi-

cates "do not constitute a written contract within the meaning of Sec. 26 (c) (1) of the Revenue Act of 1936." (R. 17). The Record shows, without contradiction, that the original holders of the preferred stock were not the same as the holders of common stock. (R. 43-44).

The preferred stock was issued by the corporation and accepted by various creditors and investors in good faith and with special reliance upon the provision against any dividends until their debt or investment had been paid in full. This agreement was complied with punctually by the corporation and no dividend was paid until the preferred stock was paid off and retired in 1939. The Commissioner conceded in his brief in the 5th Circuit Court (Page 13) that under ordinary principles of contract law the certificates in question *did* represent an enforceable agreement between the corporation and its preferred stockholders, but argued that it was not the kind of agreement to which the statute has reference.

The Decision Below.

The Fifth Circuit held that the stock certificates were not contracts under said Sec. 26 (c) (1). (R. 81-86). It based its decision upon "*Helvering v. Northwest Steel Mills*," 311 U. S. 46. It said that while the precise question in the *Northwest Steel Mills* case was whether the provisions of a state statute could be read into a corporate charter so as to form a contract containing the restricting provisions required by Sec. 26 (c) (1), much of what was said is applicable to the facts of this case. It said that it found "most persuasive" the holding (in the *Northwest Steel Mills* case) that the credit was intended to apply only

to corporations contractually obligated to set earnings aside for the *payment of debts*. Circuit Judge Hutcheson disagreed and wrote a dissenting opinion criticizing the conclusion of the majority that the taxpayer is not entitled to the credit it claimed. He stated that the majority opinion was "bottomed on a dictum contained in an opinion of the Supreme Court which decided an entirely different question arising on an entirely different set of facts from that presented here". He expressed the view that his Court,⁽¹⁾ as well as this Court,⁽²⁾ has considered it settled that when a statute is plainly and clearly written it must be applied as written, even where such construction advantaged the taxpayer.

Specification of Errors.

1. The Fifth Circuit Court erred in holding that the provisions prohibiting dividends in the charter and stock certificates of transferror corporation do not constitute a written contract executed by the corporation. The stock certificates were written and signed by the corporate officers, delivered to and accepted by the preferred stockholders, thus evidencing an explicit understanding which constituted a written contract executed by the corporation within the meaning of the statute.

2: The Fifth Circuit Court erred in holding that the case of *Helvering v. Northwest Steel Rolling Mills*, 311 U. S. 46, was decisive of the present controversy. This Court held in that case that a state statute prohibiting a deficit corporation from paying dividends was not a written contract executed by the corporation. What prevents

(1) *Sabine Tr. Co. v. Commissioner*, 128 F. (2) 945; 87 L. Ed. 373.

(2) *Helvering vs. Credit Alliance Corporation*, 318 U. S. 107.

the payment of dividends here is an express and binding contract evidenced by the stock certificates completely and entirely forbidding the payment of dividends.

3. The Fifth Circuit Court erred in holding that Sec. 26 (c) (1) of the 1936 Revenue law requires that the credit against surtax upon undistributed profits only applies to corporations contractually obligated to set earnings aside for the payment of debts. It is sub-section (2), not sub-section (1), of this same section of the 1936 Act which pertains to contracts dealing with the disposition of earnings and profits in discharge of debts.

Summary of Argument.

Hercules Gasoline Company, Inc. (Louisiana) had issued prior to May 1, 1936, preferred stock certificates containing an express prohibition against the payment of any dividends until all of the preferred stock was paid and discharged in full. During the entire tax year, 1937, these outstanding certificates amounted to a total of 1294 shares of the par value of \$50.00 per share, a total of \$64,700.00.

Congress, in 1936, levied a surtax on undistributed profits of corporations but particularly provided that *credits shall be allowed* to corporations which have placed it beyond their power to declare dividends. Cf. Appendix 29. The law required a written contract expressly dealing with the payment of dividends executed prior to May 1, 1936. The only objection raised by the Commissioner to

the preferred stock issue of transferror corporation is that the preferred stock issue of the corporation "does not constitute a written contract". There is no dispute that the issued stock certificates expressly deal with the payment of dividends or that they were executed prior to May 1, 1936. Thus the sole issue here is whether the certificates constituted a "contract".

Petitioner maintains that the corporation was bound by a valid contract with its preferred stockholders to pay no dividend until all of the preferred stock was recalled and discharged in full. Petitioner maintains that Congress did not define or distinguish the contracts which it had in mind and that the language used in the law is plain and unambiguous. The enforcement of the undistributed profits tax by the Commissioner in the present case levied under Section 14 of the 1936 Act disregards Sec. 26 of the same law and petitioner argues that such construction distorts the law and would force corporations to violate their valid written agreements in order to avoid the tax imposed.

Petitioner maintains further that the Fifth Circuit Court in the decision under review put its decision on erroneous grounds when it stated that the decision in *Northwest Steel Rolling Mills* case applied to the facts present here. This case involves certificates of stock containing an explicit understanding which was reduced to writing, signed by the President and Secretary of the corporation, whereas the *Northwest Steel Rolling Mills* case involved no such contract but only a statute prohibiting

deficit corporations from paying dividends. Petitioner maintains that when the Fifth Circuit Court said that it found "most persuasive" the holding in the *Northwest Steel Rolling Mills* case that the credit was intended to apply only to corporations contractually obligated to set earnings aside for the payment of debts, it thereby disclosed its lack of apprehension of this Court's decision in the cited case. By this line of reasoning, the Court showed that it was deciding the issue under Section 26 (c) (2) of the Revenue Act of 1936, which limits any contract to one concerning the discharge of debts, instead of under Sec. 26 (c) (1) which applied to an outright prohibition against dividends by a written contract with anyone.

ARGUMENT.

I.

The Fifth Circuit Court erred in holding that the provisions prohibiting dividends in the charter and stock certificates of transferror corporation do not constitute a written contract executed by the corporation. The stock certificates were written and signed by the corporate officers, delivered to and accepted by the preferred stockholders, thus evidencing an explicit understanding which constituted a written contract executed by the corporation within the meaning of the statute.

That the respective rights and obligations of the corporation and the stockholders as set forth in a certificate of stock becomes a contract between the corporation and the stockholders seems to be held with such unanimity

by the courts of the land that it seems strange that the contrary should be seriously argued.

See:

Words & Phrases (Perm. Ed.) "Contract" Vol.

9, p. 226-267, 1945 Supp. p. 56;

Warren v. King, 108 U.S. 389, 27 L. Ed. 769;

Geiger v. American Seeding Machine Co., 124

Ohio St. 222, 177 N.E. 594, 79 A.L.R. 614;

11 *Fletcher Cyclopedia, Corps.*, Perm. Ed., Sec.

5295, page 730.

Chase v. Hibernia Nat. Bank, 44 La. Ann. 69,

10 So. 379;

13 *Am. Jur.* 224, 398;

Gallagher v. New York Dock Co., 19 N. Y. S.

(2nd) 789;

Lee v. Fisk, 109 N.E. 833.

U. S. Radiator Corp. v. State of N. Y., 101

N.E. 732, 46 LRA (NS) 588;

Annotation: 154 ALR 418;

Strout v. Cross, A&I Lbr. Co., 28 NE (2d)

890, 133 ALR 646;

Annotation: 133 ALR 653.

It is well established in our jurisprudence that obligations not set forth at length in a written contract may be incorporated by specific reference or even by implication.⁽¹⁾

The Louisiana Corporation Law, Act, 250 of 1923, is a State enactment of the Uniform Business Corporation

(1) *Helvering vs. Northwest Steel Rolling Mills*, 311 U. S. 49.

Law. Section 14 of this statute, as amended, sets forth the form and content of certificates of stock; sub-section II of Sec. 14 provides that "Every certificate of stock shall state

(e) "If the corporation is authorized to issue shares of more than one class, the rights, voting powers, preferences and restrictions granted to or imposed upon the shares of each class, or a *reference to the articles relating thereto*." See Appendix, p. 31.

It is common practice in Louisiana to refer to the Articles and thus save extensive printing on the face of stock certificates. Hercules Gasoline Company, Inc., observed this practice and followed this law by referring on the stock certificates, both common and preferred, to Article V of the charter.

Louisiana has the Uniform Stock Transfer Act—Act 180 of 1910—under which the title to corporate shares passes by delivery of the certificate of stock. Thus, it was not necessary for the preferred stockholders to sign anything in order to bind the corporation, any more than for the purchaser in a cash deed, or the buyer of a note or a bond issue to subscribe. These stock certificates were written and they were "executed by the corporation." Furthermore, they were paid for and accepted by the holders and owners as obligations of the corporation.

The original bill in Congress, after discussion and amendment in Committee, finally came out of the legisla-

tive mill with the word "contract" and thereupon the law of the land said "contract". This is a generic word, comprehending every species and character of agreement.

Under our constitutional organization, the governmental powers are distributed among three departments, legislative, executive and judicial. Courts have no legislative authority and they should avoid judicial legislation or an entry into the legislative field.⁽¹⁾ It is not within the province of a court, in the course of construction of a statute, to make or supervise legislation. A statute may not, under the guise of interpretation, be modified, distorted or rewritten, or given a construction of which its words are not susceptible. To depart from the meaning expressed by the words of a statute is to alter it and is not construction, but legislation.

The *Louisiana Civil Code*, Article 1761, defines a contract as follows:

"A contract is an agreement by which one person obligates himself to another, to give, to do or permit, or not to do something, expressed or implied by such agreement."

A contract is defined in *12 Am. Jur.*, page 496, as follows: "An agreement by which a person undertakes to do or not to do a particular thing." Cf. *Louisiana Act 250 of 1928, Section 1 and Section 14*. See *Restatement of the Law, Contracts*, p. 1.

A controversy very similar in nature to the present case, where conclusions were reached contrary to the deci-

(1) *Iselin vs. U. S.*, 270 U. S. 245, 250, 251; 70 L. Ed. 569.

sion under review, is that of *Lehigh Structural Steel Company v. Commissioner*, 127 F. (2nd) 67, decided by the Third Circuit Court in 1942.

The Court said:

"Where amendment of Delaware corporation charter, accepted by stockholders and filed with Secretary of State of Delaware provided for sinking fund for retirement of preferred stock by setting aside percentage of net earnings after payment of preferred dividends and before paying other dividends, and such provision was set out in preferred stock certificates, corporation in determining undistributed profits surtax was entitled to credit for so much of profits, as corporation paid into sinking fund on ground that each certificate constituted a 'contract' within statute authorizing credit for surtax purposes for profits which corporation could not distribute as dividends without violating written contract executed by corporation." Revenue Act 1936, No. 14, 26 (c) (1) 26 U.S.C.A., Int. Rev. Acts, pages 823, 836.

"We are clear that nothing ruled in the Northwest Steel Rolling Mills Case is dispositive of the present situation. In the present case the parties reached an explicit understanding, as is evidenced by the amendments to the certificate of incorporation proposed by the petitioner's Board of Directors, accepted by the stockholders and filed with the Secretary of State of Delaware. The agreement was thereafter set forth in detail in the

stock certificates, each of which was executed by the corporation and each of which dealt expressly with the payment of dividends. Finally these writings were delivered by the corporation to the parties with whom it was contracting, namely, the owners of its stock. We conclude that the stock certificates which were issued by the petitioner prior to May 1, 1936, meet the statutory test. The petitioner was, therefore, entitled to the credits claimed."

See also:

Budd v. Commissioner, 143 F. (2) 784;

Philadelphia Record Company v. Commissioner, 145 F. (2) 613;

Eljer Company v. Commissioner, 134 F. (2) 251.

The case of *Rex-Hanover Mills Company v. U. S.*, 53 F. Supp. 235 is a controversy involving similar facts and the same legal issue as involved herein and was decided by the Court of Claims in 1944.

The Court said:

Agreement of corporation printed on preferred stock certificates issued in 1933 requiring corporation to provide a sinking fund before payment of dividends on any class of stock other than preferred stock constituted a "written contract executed by corporation" restricting payment of dividends within statute authorizing credit for surtax purposes for profits which corporation can-

not distribute as dividends without violating such a contract. Revenue Act 1936, Secs. 14, 26 (c) (1)
26 U.S.C.A. Int. Rev. Acts, pages 823, 836.

The facts in the present case establish a contract relationship between the corporation and its preferred stockholders. The owners of this stock accepted the preferred stock issued to them under the guarantees supporting the sale of the stock and with the full intention of getting back their interest and principal before there should be any distribution of earnings by the corporation to the common stockholders. There was a meeting of minds on this point.

In the case of *Montpelier Academy Trustees v. George*, 14 La. 395, the Supreme Court of Louisiana, over 100 years ago, stated that incorporators acquired vested rights in the nature of a contract which cannot be taken from them by the State without a manifest violation of the Constitution of the United States. The Supreme Court of Louisiana, in the case of *Boykin and Lång v. Shaffer*, 13 La. Ann. 129, followed the *Montpelier* decision and held an act of the Legislature unconstitutional as impairing the obligation of a contract.

See also:

African M.E. Church v. New Orleans, 15 La. Ann. 441;

Louisiana Board of Trustees v. Dupuy, 37 La. Ann. 188;

Carondelet Canal & N. Co. v. Lugger, et al., 37 La. Ann. 100;

Boisdere v. Citizens Bank, 9 La. 506;
Hunter v. Chicago Lbr. & Coal Co., 156 La. 19,
 100 So. 35.

Cf. Sutton v. Globe Knitting Works, 276
 Mich. 200; Note 105 ALR 1452; 117 ALR
 1290.

Treigle v. Acme Homestead Assn., 297 U. S. 189, 80
 L. Ed. 575, held as follows:

"Contracts between members of building and loan associations and the associations can not be abrogated, for no discernible public purposes, under the guise of amending the charter powers of the corporation." (Reversing 181 La. 941).

The primary purpose of this surtax upon undistributed profits was to stimulate the distribution of corporate dividends so that the tax could be collected from individual shareholders.⁽¹⁾ It is a fundamental principle of statutory construction that the intention of the legislature is the most important guide and that it will be presumed that unfair and undue hardships are not intended. The Commissioner in the administration of this law, instead of giving the law a literal construction, attempts to say that Congress only intended to give credit against the tax *under certain types of contract*, and that a preferred stockholder-corporation is not the type he thinks Congress meant. Congress must be presumed to give these words their plain and ordinary meaning. A "written contract" embraces all kinds of written agreements made by the corporation.

(1) *Reed Drug Co. vs. Commissioner*, 130 F. (2nd) 288.

This Court has (*Hawaii v. Mankichi*, 190 U. S. 214, 47 L. Ed. 1021) stated that nothing is better settled than that statutes should receive a sensible construction, such as will effectuate the legislative intention, and, if possible so as to avoid an unjust or an absurd conclusion.

See: •

Barret v. Van Pelt, 268 U. S. 85-90, 69 L. Ed. 857;

Fleischman Con. Co. v. U. S., 270 U. S. 349, 70 L. Ed. 624.

Eminent authorities on the subject of Federal Taxation have pointed out the distinguishing features of 26 (c) (1) and 26 (c) (2) of the statute, stating that one relates to prohibitions on distribution and presumably including preferred stock and other contracts, the other sub-section referring to amounts used to pay corporate debts.⁽¹⁾

The Internal Revenue Bureau of the Government in 1937 and 1938 gave credit for these contracts with much more liberality.⁽²⁾ This attitude of interpretation even went so far as to allow credit under Sec. 26 (c) (1) by virtue of provisions in preferred stock certificates.⁽³⁾

The Second Circuit Court, in *Monarch Theatres, Inc., v. Commissioner*, 137 F. (2nd) 588 considered a legend

(1) Paul and Mertens, Law of Fed. Income Taxation, 1939 Cumulative Supp., Secs. 32A39, 32A40, 32A43 and 32A45B;

(2) I. T. 3130, Int. Rev. Bulletin, Cumulative Bulletin, 1937-2 (July-December 1937) page 107-9;

(3) I. T. 3139, Int. Rev. Bulletin, Cumulative Bulletin, 1937-2 (July-December 1937) page 111; I. T. 3152 Int. Rev. Bulletin, Cumulative Bulletin 1938-1 (January-June, 1938) page 155.

on stock certificates concerning dividends and concluded that even though the Court should agree that a shareholder's certificate was a contract executed by the corporation, it would not serve as a prohibition because it was not a promise not to pay dividends. The Court granted credit to the corporation, however, under a corporate resolution, stating that a resolution of the directors of the corporation amounted to a contract because it was reduced to writing and executed by the Board of Directors and was binding on the corporation in respect to the provision limiting the power to declare dividends.

Along the same line, the Sixth Circuit Court recently held, in *Automotive Parts Company v. Commissioner*, 134 F. (2nd) 420 that a telegram from a creditor, a letter from the corporation agreeing to limit dividends and an approving letter from the creditor, when considered as a whole agreement, constituted a written contract executed by the corporation under this law.

Other cases not concerning stock certificates but involving the question of what constitutes a restrictive contract, are *Harding Glass Company v. Commissioner*, 142 F. (2nd) 41 and *U. S. v. Hillcrest Inv. Co.*, 147 F. (2nd) 194.

We confidently believe that Congress did not intend to tax a corporation for not distributing its profits if the corporation had made a binding agreement not to distribute its profits. The best evidence that this was the law maker's intention is found in the plain and understandable language used in the enactment. We ask that

the provision be literally construed. We cannot presume an intention to place a premium on a breach of contract or to give a credit when an illegal distribution was made. We are confident that the facts in the present case meet the statutory test and clearly establish a contract relation between the corporation and the holders of preferred stock for which credit should be given.

II.

The Fifth Circuit Court erred in holding that the case of *Helvering v. Northwest Steel Rolling Mills*, 311 U. S. 46 was decisive of the present controversy. This Court held in that case that a state statute prohibiting a deficit corporation from paying dividends was not a written contract executed by the corporation. What prevents the payment of dividends here is an express and binding contract evidenced by the stock certificates completely and entirely forbidding the payment of dividends.

The Fifth Circuit Court said that they thought the reasoning and pronouncements of this Court in the *Northwest Steel Rolling Mills* case applied to the facts present here. The Court admitted that the precise question in that case was whether the provisions of a state statute could be read into a corporate charter so as to form a restrictive contract, but it thought that much of what was said in that case was applicable to the present case involving stock certificates.

The Tax Court had not felt bound by the rule of this Court in the *Northwest Steel Rolling Mills* case. The

Fifth Circuit Court held that the principle of the *North-west Steel Rolling Mills* case applied even when Government counsel in brief in the Fifth Circuit conceded that the certificates in question *did represent* an enforceable agreement between the corporation and its preferred stockholders,—which admission had eliminated the main feature of the *Steel Mills* case. There is no suggestion in the recorded opinion of the *Steel Mills* case that the stock certificates added anything to the restriction contained in the law of Washington.

In the opinion of this Court, delivered by Justice Black, you stated the crux of the matter thus:

“We must therefore decide whether Sec. 26 (c) (1) authorized a credit or deduction to corporations prohibited by state law from distributing dividends.”

Of course, with the admission by the Respondent in the 5th Circuit Court that under ordinary principles of contract law the preferred stock certificates *did represent* an enforceable, written contract, the decision of this Court denying credit to corporations prohibited by state law had no logical bearing whatsoever upon the legal issue. That case could not serve as authority for a decision involving an actual, written agreement between competent parties. By their holdings, the Fifth Circuit Court failed to follow the outright rule of the *Steel Mills* case as to Sec. 26 (c) (1) but accepted as binding the *obiter dicta* of said case under Sec. 26 (c) (2). See the criticism of

this holding by Judge Hutcheson in his dissenting opinion. (R. 84).

The Fifth Circuit Court also said that Your Honors in the *Steel Mills* case held that the prohibition against dividend payments must be expressly written in the executed contract and could not be incorporated therein by reference, implication or otherwise. We submit that there was no such holding by Your Honors in the cited case. May we refer again to the language of the Court:

"The natural impression conveyed by the words 'written contract executed by the corporation' is that an explicit understanding has been reached, reduced to writing, signed and delivered. True, obligations not set out at length in a written contract may be incorporated by specific reference or even by implication."

The Fifth Circuit raised this technical point for the first time. The Commissioner has never disputed the validity of a written contract incorporating specific provisions by reference.

Matters contained in other writings which are referred to may be regarded as a part of the contract and may, therefore, properly be considered in the interpretation of a contract. Where a contract is executed which refers to another instrument or makes the conditions of such other instrument a part of it, the two will be interpreted together as the agreement of the parties. Two instruments executed at the same time as one transaction in order to effectuate a single purpose, and each referring

to the other, must be considered together.⁽¹⁾ The law of Louisiana governing the organization of business corporations (Appendix, p. 31) authorized this reference in the charter to the certificates. Mortgage contracts in Louisiana are merely brief promises to pay in note form which are identified by the Notary with the act of mortgage which procedure by reference makes all of the provisions of the recorded mortgage a part of the written note.⁽²⁾ See also *Guerini Stone Co. v. Carlin*, 240 U. S. 264.

The *Steel Mills* case is not in point to the present controversy when the test of similarity of controlling facts is applied. The language and general expressions in an opinion of a Court should be taken in connection with the facts and issues involved in the particular record under investigation in which those expressions are used and must be construed in the light of the issue in controversy in the decided case. They should not be extended beyond the controlling facts for any purpose of authority in another and different case⁽³⁾ under any theory of *stare decisis*.

The contention of the taxpayer (and the question for decision) in the *Northwest Steel Mills* case was that it was prohibited by *State Law* from distributing 1936 profits because of a previously existing deficit. The taxpayer attempted to draw into its charter the provisions

(1) 12 Am. Jur. 781 et seq.; Restatement of the Law, Contracts, p. 283; 128 ALR 1024.

(2) La. Revised Civil Code, Art. 3384.

(3) 14 Am. Jur. Courts, p. 283 et seq.

of the state law of Washington which stated that "no corporation should pay dividends except from the surplus of the aggregate of its assets over the aggregate of its liabilities." There was no contract executed by the corporation! There is a complete contract in the present case and a state law is not involved.

It would appear clear from the above discussion that the Fifth Circuit Court followed the decree of the *Steel Mills* case, but failed to follow the reasoning; that it adopted as controlling the portions of the opinion which were adverse to the present taxpayer, but disregarded the holdings in that opinion which were favorable to it.

This Court held in the cited case that all that is required under this Section of the 1936 law is "an explicit understanding, reduced to writing, signed and delivered." The certificates of stock of Hercules Gasoline Company, Inc., were signed by the President and Secretary; they contained by specific reference the dividend prohibition and they were delivered to and accepted by the preferred stockholders.

The decision of this Court in the *Steel Mills* case was, primarily, an interpretation of Sec. 26 (c) (1) of the 1936 Revenue Act: In concluding that the law does not authorize a credit when applied to statutorily prohibited dividends, the Court thought such construction of Sec. 26 (c) (1) was further supported by a consideration of Sec.

26 (c) (2). It was of Sec. 26 (c) (2) that the Court said: "That this section referred to routine contracts dealing with ordinary debts and not to statutory obligations is obvious." The Court further disposed of the claims of the taxpayer to credit as a deficit corporation by a consideration of the legislative history of Sec. 26 (c) (1). This history showed that the contract credit was never out of the bill, altho the deficit provisions were eliminated.

The 3rd Circuit in the *Lehigh* Case⁽¹⁾ did not feel bound by the *Steel Mills* decision, neither did the 2nd Circuit in the *Monarch Theatres* case,⁽²⁾ nor did the Court of Claims in the *Rex-Hanover* decision.⁽³⁾

The authority used as a foundation for the decision under review did not decide whether stock certificates forbidding payment of dividends constituted a contract within the purview of this law and it was error for the Fifth Circuit to bottom its conclusion on the *Steel Mills* case.

(1) The Court said:

"We are clear that nothing ruled in the Northwest Steel Rolling Mills case is dispositive of the present situation."

(2) The Court said:

"The often quoted language of Mr. Justice Black in the Northwest Steel Rolling Mills, supra, 311 U. S. 460 . . . was used discursively and by way of example; it is not to be understood as laying down absolute doctrine."

(3) The same idea was put thus:

"We think the Supreme Court could hardly have intended to read into Sec. 26 (c) (1) a limitation of the written agreements there mentioned to agreements with creditors, when the Court's language was directed to Sec. (c) (2) which expressly deals only with written agreements requiring that earnings be set aside for the 'discharge of a debt.'" (53 Fed. Supp. 246).

III.

The Fifth Circuit Court erred in holding that Section 26 (c) (1) of the 1936 Revenue Law requires that the credit against surtax upon undistributed profits only applies to corporations contractually obligated to set earnings aside for the payment of debts. It is sub-section (2), not sub-section (1), of this same section of the 1936 Act which pertains to contracts dealing with the disposition of earnings and profits in discharge of debts.

This portion of our argument has been covered in discussing the other points. See Brief, above.⁽¹⁾

Section 26 (c) (1) (See Appendix), *does not provide* that one who holds a contract restricting the payment of dividends or the one with whom a corporation is dealing, must be a creditor of the corporation; neither does it exclude the provisions commonly found in certificates of preferred stock. The contract credit leaves the door wide open for stockholder-corporation contracts!. The emphasis in Sec. 26 (c) (1) is upon the word "violating". If the contract will be violated by the payment of a dividend, then there is a contract credit, exactly the same as the credit which results from dividends paid. No actual payment or setting aside is required, a mere prohibition being sufficient. If there are two or more such contracts, then the largest will result in a credit.

(1) Paul and Mertens Law of Fed. Income Taxation, 1939 Cumulative Supplement, Sec. 32A39.

Thus, under the first sub-section there may be a prohibition concerning either a debt or an investment. If an issue of preferred stock must be retired before dividends are paid, such an investment contract would clearly come under the provisions of Sec. 26 (c) (1) and would qualify for the credit.

Section 26 (c) (2) is entirely different. It allows a credit where an amount equal to a portion or percentage of the profits must be paid or set aside within the year in discharge of a debt, and only to the extent that such amount has been so paid or set aside. Again, the contract must be in written form, executed before May 1, 1936, and expressly deal with the payment of dividends. As distinguished from Sec. 26 (c) (1) however, only a debt qualifies; the contract necessarily must be with a creditor of the corporation.

When the 5th Circuit Court said that the credit under Sec. 26 (c) (1) was intended to apply only to corporations contractually obligated to set earnings aside for the *payment of debts*, and stated that it found this element of the case, "most persuasive", it thereby reveals reversible error because a mere glance at the Congressional enactment makes the Court's illogical thinking so plain that "He who runs may read".

Conclusion.

For the foregoing reasons, it is respectfully submitted that the judgment of the Circuit Court of Appeals for the Fifth Circuit should be reversed and petitioner be decreed entitled to the credit which it claimed.

Respectfully submitted,

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APPENDIX.

- Sec. 26 of the Revenue Act of 1936, 49 Stat. 1648, 1664
(26 U.S.C.A. Int. Rev. Acts, page 835-6):

Sec. 26. Credits of Corporations:

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

• • • • •

(c) Contracts Restricting Payment of Dividends.

(1) Prohibition on payment of dividends.

An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) Disposition of profits of taxable year.

An amount equal to the portion of the earnings and

profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purpose of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) Double credit not allowed. If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

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Sec. 14 of Act 250 of La. Legislature for the year 1928,
as amended:

Certificate of stock—Form of certificate.—

I. Every shareholder shall be entitled to a certificate of stock signed by the president and secretary, or by such other officers of the corporation as the articles or by-laws may provide;

II. Every certificate of stock shall state:

(a) the state of incorporation;

(b) the name of the registered holder of the shares represented thereby;

(c) the number and class of shares represented thereby;

(d) the par value of each share represented, or a statement that such shares have no par value;

(e) if the corporation is authorized to issue shares of more than one class, the rights, voting powers, preferences and restrictions granted to or imposed upon the shares of each class, or a reference to the articles relating thereto.

III. A certificate for shares having no par value shall not state any par value, nor any value thereof in money, except in liquidation or redemption, nor any rate of dividend to which such shares shall be entitled, in terms of a percentage of any par or other value. (Acts 1928, No. 250, Sec. 14; 1932, No. 65, Sec. 1).